NYLS Journal of International and Comparative Law

Volume 10
Number 2 *VOLUME 10 NUMBER 2 1989*

Article 4

1989

THIRD WORLD DEBT: PAST, PRESENT AND FUTURE

Eric J. Dale

NOTES

THIRD WORLD DEBT: PAST, PRESENT AND FUTURE

I. INTRODUCTION

The world debt crisis is arguably the most critical and far-reaching international issue of the decade. Its legal, political and socio-economic ramifications permeate the governments of virtually every nation, multinational corporation and financial institution, as well as individual consumers. Throughout the 1970s, and particularly the 1980s, public and private instrumentalities experienced market gyrations which began with periods of prosperity, stemming from great influxes of capital and lenient credit policies, and led to the current predicament of unstable economic indicators, less stable developing countries, and an unprecedented international debt dilemma. While the debt has continued to burgeon, viable solutions to curtail it are scarce.

It is impossible to effectively evaluate the various proposals for alleviation of third world debt without first understanding the events that brought it to its current position. Section II of this Note will discuss these events, noting from the benefit of hindsight whether and how intervention may have been desirable as a measure to relieve debt burdens before they reached the level of crisis. In Section III, traditional attempts to cure the debt will be examined. While these attempts have not proved successful, it is imperative to realize the sensitive socio-political nature of the debt problem and the corresponding pressures that have disrupted tools which would otherwise have been effective in disposing of debt. Section IV will explore more recent, less traditional approaches toward debt alleviation. While some of these include new financial instruments and investment techniques, it is interesting to note that often what is deemed to be new is simply a variation or fine-tuning of the traditional.[1] This section will also compare the old and the new

---

1. There has yet to be any single panacea; therefore, each new suggestion, on first impression, may appear to be easily implemented. Because each suggestion comprises a different approach to alleviation, varying results may arise. After determining the viability of an approach, it may complement the central notion. Due to potential conflicts of approach styles and extreme administrative burdens, however, a single, or more reasonably a few, vehicles that would accommodate most of the new ideas would be more desirable. Narrowing the scores of suggestions into a few workable approaches is extremely

proposals and try to achieve some degree of synthesis by which the best parts of each may be maintained while eliminating those that are problematic.

Underlying this discussion will be questions that necessarily must be confronted in any account of third world debt problems. Who are the parties involved? How are loans to lesser-developed countries ("LDCs") to be enforced? What happens in the event of default? These concerns are central in developing a workable, effective program aimed at shrinking the debt.

II. WHY WE ARE WHERE WE ARE

In 1973-74, the Oil Producing and Exporting Cartel ("OPEC") announced large increases in the price of oil. As the price of oil went up, so did the revenues of the OPEC members. These revenues, called petrodollars because they were raised by the sale of petroleum, resulted in a tremendous availability of funds for investment. In an effort to achieve a favorable rate of return on money, while still maintaining a secure investment, OPEC "dumped" much of their newly created petrodollars into American banking institutions.[2] This sudden influx left United States banks with a great deal of liquid capital. Conveniently, while these banks were looking for investments, less developed countries were seeking United States petrodollars.

At the time it appeared to be a perfect marriage. The prospects of the LDCs were bright. They had an abundance of untapped natural resources, and the global environment was ripe for development. World oil and commodity prices were high and climbing, and it was these industries in which the LDCs had the greatest potential for development.[3] Mexico, in particular, had a vast oil producing capability. These factors made loans to LDCs appear to be very secure investments. Rich oil and commodity reserves, coupled with the trend in world markets, made the ability of LDCs to repay debt appear strong. Because developing countries were believed to be a good investment, and because the investor-banks had substantial capital reserves, the banks began to compete against each other to offer the best rate of interest to the LDCs on their loans.[4] As a result, loan spreads thinned while global inflation

---

complicated because of the innate inconsistencies between theories. Hence, mere reconciliation of these ideas is inherently problematic.

2. Note, *Treasury Secretary James Baker's "Program for Sustained Growth" for the International Debt Crisis: Three Steps Toward Global Financial Security*, 4 DICK. J. INT'L L. 275, 277 n.14 (1986).

3. W. CLINE, INTERNATIONAL DEBT: SYSTEMATIC RISK AND POLICY RESPONSE 6-8 (1984).

4. McNamar, *The International Debt Problem: Working Out A Solution*, in THE GLOBAL FINANCIAL STRUCTURE IN TRANSITION, CONSEQUENCES FOR INTERNATIONAL FINANCE AND

rates remained high.[5] Therefore, the real rate of interest LDCs were paying was often negative.[6]

In this type of credit environment, it is easy to understand why a country would continue to refinance. Economically, it was cheaper because high inflation decreases the real debt over time by decreasing its present value. Furthermore, because the LDCs were borrowing from commercial banks, there were no exterior conditions tied to their loans. They could receive financing with their only obligation being to maintain their service schedule. The LDCs did not have to spend on particular programs, invest in particular industries, or alter their consumption. In contrast, loans from the International Monetary Fund (the "IMF") offer financial support but make borrowing dependent upon other terms.[7]

Of the terms imposed upon the LDCs by the IMF, the most distasteful is the implementation of austerity programs.[8] An austerity policy redirects money from current domestic programs toward longer term investment projects in order to stimulate growth and productivity and promote an increased quality of life in the future. By definition, however, such a policy detracts from current living conditions.[9] Austerity programs therefore, are politically problematic for governments of borrowing countries because their citizens will generally not welcome cut-

---

TRADE 127, 128 (J. McClellan ed. 1985).

5. *Id.* A loan spread represents the difference between the rate of interest charged and the rate of interest the bank must pay its depositors. The difference between the rate of inflation and the rate of interest being charged is known as the real rate of interest. A primary way for lenders to compete is to reduce the interest rate they charge. As a result the real rate of interest as well as the loan spread decline. Because a rate of interest charged should reflect the risk involved in the loan, as the interest rates decline the risk should be declining. In the case of the LDCs, however, it was not that the risk of the venture was declining but rather that the competition among creditors was driving the real rate of interest down. *See id.*

6. *Id*; *see also*, Bohn, *Governmental Response to Third World Debt: The Role of the Export-Import Bank*, 21 STAN. J. INT'L L. 461, 462 (1985) (if the rate of inflation exceeds the rate of interest being charged, then the real rate of interest is negative).

7. Note, *supra* note 2, at 278.

8. On March 6, 1986, the Intergovernmental Group of 24 issued a press communique after their meeting. *Group of 24 Communique . . . Developing Countriess Call for New Efforts on Debt, Foreign Aid, and Monetary Reform*, *reprinted in* 15 IMF SURVEY 90 (Mar. 17, 1986). They emphasized that traditional short-term adjustment policies were not compatible with the attainment of long-term equilibrium and that austerity programs fail to take sufficient account of the seriousness of the structural problems that the LDCs face. *Id.* Furthermore, they asserted that continual renegotiation leads to uncertainty by prolonging debt service problems rather than addressing them and thereby has a negative effect on their economic, social and political prospects, hence, seriously affecting the standard of living and threatening social and political stability. *Id.*

9. *See id.*

backs in their already weak economies.[10] Consequently, if financing that is not based on austerity terms is available, borrowers will tend to accept the condition-free loans in order to avoid adverse changes in their lifestyle. This method of short-sighted decision making ignores the goal of long-term development pursued by each of the players— debtors, creditors, and the global community—as well as the consequences of unguided spending, such as increased domestic spending and inflation without a corresponding increase in domestic productivity. Ignoring these factors results in the need for continued exterior financing and the accumulation of debt.[11]

Perhaps the debt crisis might have been avoided if LDCs had accepted austerity, with its long-term development goals, as many creditors had encouraged them to do in the 1970s. Practically, however, human nature will not adopt such forward-looking policies absent sufficient provocation.[12] A more fundamental reason for the debt crisis exists, however, than merely rejecting the exercise of self-constraint. Because low interest and high inflation rates made borrowing virtually free.[13] Continued debt financing need not be fatal if the funds are properly allocated. For instance, had the LDCs invested the borrowed capital in programs designed to increase the efficiency, and hence the competitiveness, of their local industries while also allocating a portion to consumer spending, growth may have ensued while the LDCs maintained a desirable standard of living and provided the economy with the capital to meet the expanding output.[14] This policy agenda was not adopted. Instead, the LDCs used the money to finance consumption,[15] without accounting for the plight that might develop if interest rates rose and inflation fell, resulting in indebtedness at high real rates of interest without assets to show for debt that had been incurred.

In the early 1980s, this hypothetical dilemma became reality. In an effort to curb runaway inflation, interest rates were allowed to climb.[16]

---

10. Note, *supra* note 2, at 279.

11. *See id.*

12. For the same reasons that it is socially, politically and economically unfavorable for an LDC to adopt austerity programs, see *supra* notes 8-10 and accompanying text, a government will not seek to produce future benefits at the expense of the current quality of life. Additionally, because the "marginal" standard of living is considerably lower in an LDC then in a developed nation, diminishing the quality of life in an LDC would produce a greater hardship upon its inhabitants. *See supra* note 8.

13. The economic forecast in the early 1980s led the governments, both creditor and debtor, and the banks to believe that interest rates were not going to experience much of a rise while inflation would continue. McNamar, *supra* note 4, at 128-29.

14. *See id.*

15. *Id.*; *see also* Bohn, *supra* note 6, at 462.

16. J. GUTTENTAG & R. HERRING, THE CURRENT CRISIS IN INTERNATIONAL LENDING 13-

As interest rates increased, the commodity and oil markets were badly hurt.[17] Suddenly, the LDCs were left to pay high real interest rates while at the same time their income was reduced, and their actual levels of growth and development were essentially the same as a decade before.[18] Most commentators will agree that what we now refer to as the debt crisis came to fruition in August 1982 when the Mexican Government informed the United States Treasury that its foreign exchange reserves were depleted and it would no longer be able to make payments to its creditors, or, in other words, to service its debt.[19]

Shortly after Mexico announced its inability to service its debt, other debtors followed suit.[20] In an effort not to erase the debt from the banks' books,[21] reschedulings became widespread. Refinancings[22] were more difficult to obtain.[23] Banks began to look to shorter terms to avoid the impact of vulnerability and exposure.[24] Furthermore, much of the debt was concentrated among a few large banks.[25] Because the consequence of writing off these debts might have had a catastrophic impact on international banking, as well as on every bank customer, the world financial and political communities were forced to band together to try to develop solutions.

---

14 (1985); McNamar, *supra* note 4, at 129-30.

17. For a brief discussion of the effect of certain economic indicators, such as the interest rate and the inflation rate, on the commodities market, see generally Note, *supra* note 2, at 280 and Bohn, *supra* note 6, at 463.

18. Note, *supra* note 2, at 280-81.

19. *See* McNamar, *supra* note 4, at 128; *see also* Bohn, *supra* note 6, at 461.

20. In 1980, it was suggested that banks were beginning to become concerned about the level of development in debtor nations. *See OECD Foresees Decline in International Lending to Some $100 Billion*, 9 IMF SURV. 637 (Aug. 4, 1980) (OECD is the abbreviation for the Organization for Economic Cooperation and Development) [hereinafter *OECD Foresees Decline*]. By 1983, the problem became more pronounced with the surge of rescheduling requests. *See* Heineman, *Third-World Debt Problem*, N.Y. Times, Mar. 10, 1983, at D1, col. 3; *see also* Gilpin, *The Maze of Latin America's Debt*, *id.*, Mar. 13, 1983, § 3, at 4, col. 3.

21. *See* J. GUTTENTAG & R. HERRING, *supra* note 16, at 2-4.

22. A rescheduling agreement extends the time period for the repayment of the debt. Refinancing involves the issuing of additional credit, often simply to enable the borrower to service previously issued debt. Because refinancing requires new cash infusions by the lender instead of merely extending the terms of older loans, it is generally more difficult to obtain. *See* Lovett, *Managing the Debt Crisis: Economic Strains and Alternative Solutions*, 21 STAN. J. INT'L L. 499, 513-16 (1985).

23. J. GUTTENTAG & R. HERRING, *supra* note 16, at 2-4.

24. *Id.*; *see also OECD Forsees Decline*, *supra* note 21, which reported how banks began to look deeper into the credit worthiness of borrowers.

25. J. GUTTENTAG & R. HERRING, *supra* note 16, at 2-4; *see also* Note, *supra* note 2, at 279-81. While almost every substantial banking institution suffered from third world debt exposure, banks such as Citicorp, Manufacturers Hanover, Chase Manhattan and Bank of America held particularly large positions.

III. TRADITIONAL DEBT ALLEVIATION ALTERNATIVES

The propositions that have been advanced to relieve the LDCs, the banks, and the world financial community of their respective debt burdens are plentiful and diverse. Each theory has its own cornerstone and its own inadequacies, however, among the most comprehensive and widely accepted is the proposal of former United States Treasury Secretary, James Baker III.[26]

Baker's "Program for Sustained Growth" incorporates three essential and mutually reinforcing elements:[27] (1) adoption by debtors of comprehensive macroeconomic and structural policies, supported by international financial institutions; (2) a central role for the IMF, as well as Multilateral Development Banks ("MDBs"), in support of the adoption by debtors of market-oriented growth policies; and (3) increased lending by private banks in support of comprehensive economic adjustment programs.[28]

Baker's plan is based on a theory of cooperation between all of the parties. Hence, in order to give life to such a plan, the participants (the governments, the IMFs and MDBs, and, most importantly, the commercial banks) must remain in the game. Absent their continuing participation the theme of cooperation is abandoned, leaving each bank to negotiate the best deal for itself. Of the three groups of participants, keeping the banks involved was probably most difficult to achieve. Faced with the choice of reschedule or write-off, however, and motivated primarily by self-interest, the banks made the choice to cooperate, at least with respect to roll-overs and rescheduling agreements.[29]

The decision to extend new loans to LDCs was more difficult to reconcile.[30] Baker's program called for each of the forces to act in concert. The role of the commercial banks would be to increase their

---

26. Statement of Treasury Secretary James A. Baker before the Joint Annual Meeting of the International Monetary Fund and the World Bank [hereinafter Statement of Treasury Secretary], *reprinted in* Note, *supra* note 2, at 306-15.

27. *Id.* at 306-11.

28. *Id. at 313-14.*

29. Rowen, *Jim Baker's Global Blueprint*, INSTITUTIONAL INVESTOR, Sept. 1986, at 302, 304. The Baker plan concentrates on development rather than austerity. *Id.* at 302. In order to achieve success, new funds must be extended to the LDCs. The commercial lenders, when faced with the Baker proposal, realized that if they failed to extend further credit, then development would be stifled and there would be no hope for recovering any of their loans. *Id.* at 304. By rescheduling or rolling-over debt, the creditors gave the LDCs an opportunity to develop without having to adjust their balance sheets. *Id.* Baker, however, called for the extension of additional credits.

30. *Id.*; *see also supra* note 22 and accompanying text.

loans to the LDCs.[31] Upon first impression, this measure defies logic. Banks do not generally increase current liablity in an effort to decrease prior vulnerability. Baker's program, however, is premised upon the cognizance that the debtor countries are simply unable to repay their existing obligations. In order to alter that situation they must undertake market-oriented policies toward growth and development. Market-oriented policies are aimed at making local industries more efficient and more competitive. By investing in new machinery and worker-training programs, LDCs would become more competitive in world markets. Their exports would increase and their imports would decrease, resulting in a more self-sufficient economy and an ability to service and repay their debts. Given the abundance of natural resources in many debtor nations, implementation of effective market-oriented policies could make the LDCs' economies quite competitive. Such policies require capital for implementation which must, in part, come from continued support of lending institutions.[32]

Those nations involved, however, recognize that the terms of commercial loans will no longer be condition-free.[33] Under the program, these loans will be tied to IMF approval of policies adopted by the borrowing countries.[34] In essence, although commercial loans have not traditionally been burdened with IMF conditions, under the Baker plan the IMF would have the ability to implement its policies indirectly through the commercial lenders. This "indirect-conditionality" bestows upon the IMF the power to make the ultimate decision as to who will receive commercial bank funding.[35] The banks promoted the placement of indirect pressure upon the LDCs to conform to IMF policy in an effort to force debtors to invest in growth and income-generating projects rather than the consumption-oriented programs that led them to their present plight.

---

31. Statement of Treasury Secretary, *supra* note 26, at 309.

32. *Id.* at 309-10.

33. Note, *supra* note 2, at 283-85 and accompanying text.

34. Articles of Agreement of the International Monetary Fund, Dec. 27, 1945, 60 Stat. 1401, T.I.A.S. No. 1501, 2 U.N.T.S. 39 [hereinafter IMF Articles of Agreement].

35. Certain conditions must be met for an LDC to receive IMF approval. *See* Note, *supra* note 2. Even with such approval, it must be remembered that the commercial banks still must determine whether or not to extend credit. That a country has accepted certain IMF conditions may lead a bank to believe that the country is a better credit risk thereby making it more likely that the bank will extend the credit. On the other hand, institutional lenders may recognize the lack of strict compliance with austerity programs, or even think of them as too little too late and be reluctant to advance additional credit. Given the need for global cooperation, however, as evinced by the Baker plan (*see supra* note 26), it is likely that international lending institutions will continue to advance credit while searching for new financial instruments in order to diversify their risk and clear their balance sheets.

The IMF plays a central role in Baker's proposal.[36] In addition to the link between IMF approval of policies and commercial bank lending, the IMF's role as a creditor is emphasized. IMF loans are based on strict austerity plans and development policies.[37] Furthermore, the World Bank assumes a position of greater influence under the Baker Plan.[38] The World Bank was originally designed to finance specific projects.[39] Like the IMF, the World Bank was important not only for its financial contributions but also for its role as technical advisor in the projects that it supported.[40] Problematic with the World Bank, however, was its complicated and time-consuming approval process; thus, it did not play as central a role as it could have.[41] Although its record for recovery was impressive considering its debtors, its overall impact on the crisis situation was minimal.[42] Baker's program addresses this inefficiency by making additional capital available to the World Bank and by extending the repayment terms of its loans,[43] which was relatively short.[44]

Baker's plan is the most comprehensive and recognized of any aimed at alleviation of the debt crisis. Since its commencement, however, the plan has not been able to achieve the desired results. Unexpected changes in the international economy, political problems of adopting austerity programs in debtor nations, and the difficulty of developing truly market-oriented policies have all contributed to its failure to achieve widespread adoption.[45] Before turning to some of the latest proposals that attempt either to directly or indirectly address these concerns, this Note will briefly examine one recent proposition set forth in an effort to reduce world debt. This scheme lends insight into the type of creative finance mechanisms that are being developed to combat the debt crisis.

Schools of thought are divided as to whether the debt crisis is a solvency or liquidity problem.[46] The basic difference is that if it is

---

36. *See generally* Statement of Treasury Secretary, *supra* note 26.

37. *See* IMF Articles of Agreement, *supra* note 34. The strictness of the condition of austerity of IMF loans may become more lenient in light of socio and political practicalities.

38. *See generally* Statement of Treasury Secretary, *supra* note 26.

39. Articles of Agreement of the International Bank for Reconstruction and Development, Dec. 27, 1945, art. I, 60 Stat. 1440, T.I.A.S. No. 1502, 2 U.N.T.S. 78.

40. Note, *supra* note 2, at 286.

41. *Id.*

42. *Id.* at 287.

43. *See* Statement of Treasury Secretary, *supra* note 26, at 287.

44. *Id.*; *see also* E. MASON & R. ASHER, THE WORLD BANK SINCE BRETTAN WOODS 540 (1973). The usual length of the loans was from three to five years.

45. Note, *supra* note 2, at 302-05.

46. Generally, a liquidity problem is one of cash flow. The debtor nation may have the assets to service the debt but it is currently unable to produce the case. This problem forces the debtor to attempt to renegotiate the terms of the loan by getting an extension

deemed to be a solvency problem, then the result would be to forgive much, if not all, of the debt. Such a position stems from the belief that the debtor nations are, and will continue to be, unable to service their debt, let alone attempt to pay back the principal.[47] Is such a case, banks and creditors must write off the loans. Thus, balance sheets will need to be adjusted to correspond with the write-offs and will result in a tightening of available finance capital, not only among creditors, but even among non-creditors, through a ripple-effect.[48] The necessary implications of such a position are dire.

If creditors perceive the crisis as one of liquidity rather than solvency, then they, and the international economy, will not suffer as devastating a blow.[49] Perception, however, is incidental to reality. In reality, to label a situation problematic only from a point of liquidity there must be an underlying confidence of growth and development potential. In order to realize this potential, debtors need to gain more capital inflows.

In an effort to accommodate more capital inflows, a proposal has been set forth with the objective of increasing the lender's control over the flow of capital.[50] The core of this plan is the issuance of non-maturing, floating-rate certificates called perpetuals.[51] These perpetuals would need IMF approval and a portion of the capital would have to be

---

or to attain additional financing in order to service the loan. As a result, creditors may suffer cash flow problems. Forcing the debtor into default can have disastrous consequences on the lender and potentially on the economy. Therefore, if the lender believes that the debtor is merely suffering a liquidity problem, and that the debtor will be able to alleviate that situation, it is likely that the creditor will accomodate the debtor. In doing so, domestic interest rates may rise due to the diminished supply of available, liquid cash. What is important to remember, however, is that a true liquidity problem will be of a short duration and the consequences of such a situation will be correctable. *See* McNamar, *supra* note 4, at 129-32; Lovett, *supra* note 22, at 508. Insolvency is unlike liquidity in that the debtor has neither the cash nor the assets to service the debt. The borrowing nation is simply unable to make the payments. The consequences of insolvency are more severe and less rapidly correctable than those of liquidity problems. Lending institutions may be forced to write off part, or all, of the outstanding debt and increase their reserves. Interest rates will inevitably rise. Often in insolvency situations governments become involved to attempt to alleviate the effects as much as possible. Insolvency problems generally involve a longer recovery period. *See* Lovett, *supra* note 22, at 504 n.19, 509.

47. *Id.*

48. *Id.* It is not suggested that the standard of living among creditor nations will be decreased. Writing off substantial debt, however, may have the effect of increasing interest rates thus making available domestic credit more expensive. Under traditional economic theory, increased interest rates may also impact upon employment, productivity and investment. *See id.* at 5.

49. *See supra* note 46 for a discussion of the economic benefits of addressing the crisis as a problem of liquidity rather than one of insolvency.

50. J. GUTTENTAG & R. HERRING, *supra* note 16, at 8-10, 11-15.

51. *Id.* at 7.

acquired by the IMF or a MDB.[52] Two aspects of this plan, however, make it unique. First, these certificates do not mature, hence the name perpetuals.[53] Second, the repayment schedule of these certificates would be based on a last-in first-out ("LIFO") method.[54]

There are certain advantages to such an issuance. For one thing, it encourages new investment.[55] Unlike an ordinary loan in which the lenders' claims would be last in priority, the contributors to a perpetual may feel secure in that they receive priority interest payments.[56] Also, the fact that the IMF has a role in this venture further reassures creditors that IMF surveillance practices will be followed.[57] Hence, preconditions, performance criteria and other policies which generally compliment an IMF plan will constitute a part of this issue.[58]

The adoption of perpetuals as a mechanism to finance debt becomes problematic when viewed from the perspective of pre-existing creditors. It may be argued that because we have already acknowledged only a liquidity problem and creditors are facing failing debt service, any new proposal is welcomed in an effort to relieve debt service pressures from the debtors. The problem with this position is that it presupposes a general acceptance that the debt crisis is simply a liquidity problem. This scenario is by no means as widely accepted as the writer of a perpetual would like to believe. As discussed earlier, characterization of the debt as a liquidity problem is a method which allows financial institutions to keep 100% of the debt on their books without having to record any losses. Many banks do not believe that to be the case.[59] If solvency, and not liquidity, is determined to be the factor that continues to drive the debt, then perpetuals would become a new and different way of extending credit without any hope of receiving future payments. Furthermore, such

---

52. *Id.*

53. *Id.*

54. *Id.* The goal of the perpetual is to keep the money flow constant to countries having problems servicing their debt. The LIFO method is designed to encourage the debtors to submit to IMF stabilization policies because they would have the confidence that additional financing would become available if necessary. The perpetual is part of a six-part proposal set forth by Guttentag and Herring. While it may be useful in dealing with outstanding government debt, its value in relation to private debt is less appealing. *See id.* 7-8.

55. *Id.* at 7-8.

56. *Id.* at 8.

57. *Id.*

58. *Id.* at 7.

59. Since the Mexican crises, see *supra* note 19 and accompanying text, many banks perceive the debt to be a solvency dilemma. Absent some form of global cooperation, "solvency-motivated" banks will increase their loss reserves and refuse to extend additional loans to LDCs. *See* Lovett, *supra* note 22, at 504 n.19, 509.

an argument presumes that even if the problem is deemed to be one of liquidity, existing creditors will have no objection to taking a subordinated role in repayment scheduling. Even if we are concerned with only government creditors at this juncture,[60] it is unlikely that they will allow their earlier claims to be subordinated to a new LIFO strategy. Furthermore, when private creditors enter the scenario, the issues become all the more complex. The LIFO method simply means that the most recent creditor to extend funds will be the first one to receive payments by the debtor. Only after the newest creditor's debt is serviced would prior creditors receive any service on their loans.[61] Given the history of the debtors' inability to pay, it is unlikely that, in the short run, an LDC would be able to pay off the perpetuals and have enough resources remaining to service other debts. The commercial creditors, however, have based their loans on short-term payments and would probably be unwilling to take a junior position to subsequent creditors. Even if some were willing to assume such a position, it would mean massive reschedulings and perhaps current write-offs and increased reserves for the banks.

Additionally, although the perpetuals are based on a plan in which there is no principal,[62] only interest, the creators of this plan have ignored what appears to be a fatal flaw. They appear to premise the plan on an assumption that the true burden of existing credit is the principal.[63] In practice, however, debt-service or interest payments are as much of the problem as is the principal. While IMF participation may aid in the formulation of a productive strategy in order to achieve sufficient revenues to maintain the perpetual's interest payments, one must question the need for a program which includes subordination of existing debt. For instance, the IMF plays an active role in the Baker plan, yet existing debt still receives priority status.[64] It is questionable whether one whose claims are already in existence, and who was willing to take a risk from the outset, would be willing to undertake a similar risk in the future with the knowledge that a new financial instrument might be developed which would put its claim on the back-burner.[65]

---

60. *See* J. GUTTENTAG & R. HERRING, *supra* note 16, at 7.

61. *Id.*

62. *Id.* at 8.

63. *Id.* at 8; *see also* Note, *supra* note 2, at 275. In fact, virtually none of the LDC debtors have even begun to repay the principal, and it is the debt service burden that most of the current reschedulings and refinancings are aimed at alleviating. Note, *supra* note 2, at 275.

64. Statement of Treasury Secretary, *supra* note 26. Although new creditors may not be as willing to extend financing as they would if a LIFO approach was used, they still may be willing as long as there is IMF surveillance. J. GUTTENTAG & R. HERRING, *supra* note 16, at 7. Furthermore, as a matter of fairness to existing creditors, the use of a LIFO approach is flawed. *See id.*

65. As a means of illustration, compare this scenario to the modern domestic real estate

It certainly appears that in order to find new strategies toward mitigating the world debt dilemma we must induce new players to join the game. It is also logical to develop new instruments through which these players will be able to achieve sufficient return to trigger their participation in an enterprise with a proven speculative background. To do so by prioritizing new creditor claims, however, will be self-defeating in that it will sustain a pattern of short-run relief at the expense of long-term goals. Instead, new instruments must have high return and versatility, while remaining distinct from current debt. Section IV will focus upon such instruments.

IV. FUTURE PATTERNS OF DEBT ALLEVIATION

Governmental policies toward alleviation of LDC debt will continue because richer nations will continue to feel a moral and social obligation to help developing nations. Furthermore, economic and political factors, particularly the high level of resources already allocated to development projects and a desire for global cooperation, weigh heavily in governmental contributions toward a resolution.[66] It is becoming increasingly evident that the debt crises may not be resolved without the aid of the private sector. The private sector, however, is not motivated by feelings of good will toward its international neighbors. Instead, and rightfully so, the private sector will mobilize funds when it is in its best interest to do so. Certainly, in an esoteric sense, a stable global economy is in the best interest of the entire private sector. On a more practical level, one must remember that the early private lenders extended credit to LDCs that had positive potential. For this reason, the periods of the loans were relatively short. As the loans began to come due, the banks continued to finance the LDCs to permit them to service their existing debt. As the debt grew, lenders realized that what were intended to be short-run credit extensions were turning into long-run chaos. Thus, elimination of short-term debt may only be accomplished by long-term policy goals, with the burden of the LDCs' inability to repay shifting from the LDCs to the investors and their shareholders. In addition, because the elimination of debt instruments, or loans, is probably not a viable consideration in light of the existing status of debt, commercial lenders appear to be receptive to alternative financing schemes.[67]

---

market. A first mortgagee will have serious reservations about extending a mortgage if the mortgagor may obtain a second mortgage which will have a priority over the first.

66. *See, e.g.*, Lovett, *supra* note 22; *see also* Bohn, *supra* note 6.

67. For examples of how lenders are turning to alternate schemes of financing rather than traditional loans, see Farnsworth, *U.S. Proposals Hearten IMF and World Bank*, N.Y. Times, Oct. 2, 1987, at D1, col. 5; Wayne, *Securitization, Wall Street's Newest Magic Show*, *id.*, Sept. 13, 1987, § 3, at 1, col. 2; *Debt Swapping Opens a Door*, EUROMONEY TRADE

The concerns of commercial institutions are based upon their fiduciary duties to stockholders, the numbers on their balance sheets, and their ability to diversify their LDC risk.[68] Additionally, exchange and interest rates are a central focus in financial developments.[69] Necessarily, almost every plan will encompass some governmental participation, or cooperation, as well as private sector participation, if for no other reason than to give the private investors a greater degree of confidence. Furthermore, many current plans are evolving in accordance with the Baker plan.[70] The focus of this section, however, is on the expanding role of the private sector, noting the constant involvement of the public sector in all phases of debt alleviation as well.

Under the present methods of restructuring debt, banks are often forced to make new loans in ordef to keep their outstanding loans at full value on the books. Such was the case when Brazil unilaterally stopped paying interest on 67 billion dollars of foreign bank debt on February 20, 1987.[71] Lenders were forced into agreements under which they had to contribute new money in order to avoid reclassification of existing loans to "value-impaired,"[72] which would require the banks to write down those credits by 10%.[73] Brazil is holding out for concessions, such as a one-year delay before IMF austerity conditions are implemented, before

---

FINANCE REPORT, Nov. 1986, at 4; *Forfaiting: Rates and Market Commentary*, *id.*, Oct. 1986, at 71.

68. As discussed *supra* note 5, relating to interest, the banks must make sure that their rate of interest accurately reflects their degree of risk. Similarly, if a lender's exposure to a small group of LDCs is high then the bank will suffer tremendously in the event a default occurs. In order to avoid this scenario, banks diversify their risk by loaning to several debtors. See J. GUTTENTAG & R. HERRING, *supra* note 16, at 5. If they failed to diversify from the beginning then they will engage in debt-swapping with other lenders so that each member of the swap will be able to diversify their risk. *See Debt Swapping Opens a Door*, *supra* note 67, at 4.

69. For example, interest and exchange rates are accounted for in forfaiting transactions. *Forfaiting: Rates and Market Commentary*, *supra* note 67. The importance of interest rates is discussed *supra* notes 4-6 and accompanying text. Exchange rates must also be accounted for in order to assure the value of repayment. *See* Waterman, *Swapping Banks into Forfaiting*, EUROMONEY TRADE FINANCE, Oct. 1986, at 62.

70. Because the Baker plan calls for continued support from commercial lenders, anything that permits these institutions to extend more money is in accordance with the plan. Securitization would promote this goal by packaging debt into securities which would be sold to private investors. Not only would this measure bring additional funding into the Third World but it would also free institutional funds which may then be reinvested. See Wayne, *supra* note 67. For a more elaborate discussion on securitization see *infra* notes 88-101 and accompanying text.

71. Truell, *Brazil and Banks Discuss Plan to Avert Regulatory Decision to Reclassify Loans*, Wall St. J., Oct. 27, 1987, § 1, at 2, col. 3.

72. *Id.*

73. *Id.*

they will begin to repay their interest while the banks refuse to make concessions until the interest arrears are closed.[74] This is the type of impasse faced by major LDC creditors.

In order to avoid this sort of dilemma, banks are turning toward debt swapping.[75] From 1986 to the present, debt swapping has been instrumental in permitting creditor banks and exporters to clear away existing debt.[76] This mechanism, in turn, allows these creditors to extend new capital, perhaps in another type of debt swap to be discussed *infra*. By means of a debt swap, banks agree to sell the debt of one country for that of another.[77] The purpose behind this type of transaction is to promote a more balanced investment portfolio and to diversify risk. In doing so, a technique known as forfaiting is often used.[78] By means of forfaiting, interest and exchange rates are accounted for in order to stabilize the terms of the swap.[79] Forfaiting is completed through a series of complex transactions. Basically, a series of bills of exchange or promissory notes are purchased at a fixed rate of interest. Banks involved in forfaiting must have large capital bases in order to supply the fixed rate funding requirements of the notes or bills which often have short-term payments. For this reason, very few were originally involved in the practice. By supplementing forfaiting with interest rate and currency swaps, smaller banks with lower capital bases are able to enter the forfaiting market.[80] This allows smaller private investors to enter the market and permits diversification on a wider scale.[81]

---

74. *Id.*

75. *Debt Swapping Opens a Door*, *supra* note 67, at 4.

76. *Id.*

77. *Id.*

78. Waterman, *supra* note 69, at 62. For a discussion of a new international financing technique which is designed to alleviate the high-risk confronted by a forfait note holder, see Ludwig & Coursey, *The Export Trade Note: A New Instrument for International Trade*, 16 GA. J. OF INT'L AND COMP. L. 381 (1986).

79. Waterman, *supra* note 69, at 62.

80. *Id.*; *see also Debt Swapping Opens a Door*, *supra* note 67, at 4.

81. *Forfaiting: Rates and Market Commentary*, *supra* note 67, at 71, sets forth an analysis of a country's risk assessed by the forfait market. The risk is based on the discount rate on the note issued by the importer/debtor. Because the note is backed by a reputable local bank, the risk is closely aligned to that of the country. Of the 44 debtor nations in the analysis, Brazil's discount rate was the highest at 7%. Furthermore, while the typical maturity for these notes is three to five years, Brazil's notes are the shortest, at one year. Many forfaiters ceased issuing quotes on Mexico's notes. The United States of America, along with West Germany, Switzerland and Japan had the lowest discount rate, showing international confidence in their ability to repay. Those nations, along with Great Britain, the Netherlands and Canada also had a no limit ("NL") status as to the maturity date at which discounters would accept the note. Those maturity dates are contingent upon the payment of the bi-annual servicing. *Id.*

Forfaiting is but one of the financial techniques that is becoming available to introduce more private investment into world debt situations, while encompassing practical problems such as interest rates and currency exchange rates. The other type of debt swap is a debt-for-equity arrangement.[82] In this type of situation, the following generally occurs. A debtor is unable to service its debt. Instead of looking to a classic restructure, as in the Brazilian example discussed earlier, the creditor will sell its loan at a discount.[83] The purchaser of the loan will then trade the loan in at the central bank for local currency.[84] The central bank will generally recount for the discounted value of the loan but the currency will naturally be worth less.[85] The money will then be invested in a local enterprise from which the investors seek to gain from the profits it generates.[86]

An offshoot of this debt-for-equity swap which has tremendous potential to attract new investors is a process known as securitization or equitization.[87] Securitization is a method for converting debt into equity by establishing a portfolio investment fund of existing debt.[88] The fund is capitalized by the issuance of shares.[89] These shares may be traded over the local stock exchanges of the issuing country.[90] The holder of the loans will be able to get equivalent value in shares while the loan will be discounted by a few percentage points.[91] Such a program has already been implemented in Chile.[92] The Chilean Central Bank director is anticipating that 20% of Chilean medium and long-term debt will be eliminated through the use of this type of swap within its first year.[93] Furthermore, while this type of conversion is initially aimed at current creditors, the Central Bank is anticipating the availability of such shares to new investors as well.[94]

United States investment bankers are looking at equitization as a

82. Waterman, *supra* note 69, at 62.

83. *Debt Swapping Opens a Door*, *supra* note 67, at 4.

84. *Id.*

85. *Id.*

86. *Id.*

87. Wayne, *supra* note 67; *see also* Farnsworth, *U.S. Proposals Hearten I.M.F. and World Bank*, N.Y. Times, Oct. 2, 1987, at D1, col. 5.

88. *Debt Swaps Will Finance Chilean Investment Fund*, Wall St. J., Oct. 12, 1987, § 1, at 28, col. 4 [herinafter *Debt Swaps*].

89. *Id.*

90. *See* Wayne, *supra* note 67.

91. *See Debt Swaps*, *supra* note 88.

92. *Id.*

93. *Id.*

94. *Id.*

viable option for debt alleviation, as well as a high-income-producing product for the investment houses.[95] The process is similar to that described above regarding the debt-for-equity swap except that instead of turning the loan into the central bank of the local nation, several loans may be put together in a package and sold as a security,[96] not unlike a mortgage-backed security. These securities could take different forms, backed by a single loan or a group of loans.[97]

The attraction for this type of investment comes from the potential for high returns.[98] Though an existing loan may yield a mere 8% to its creditor, if the loan is sold at a 50% discount the yield-to-investment ratio doubles into a packaged security returning 16%.[99] Great risks are necessarily involved, but high profits are achieved by those who are not risk adverse.[100]

Investors in such issues may wonder about debtor repudiation.[101] History, however, illustrates that it is not in any party's best interest to repudiate.[102] Furthermore, Baker's program leaves those LDCs who want to "go it alone" to do just that. The implications politically, as well as economically, demonstrate that such action on the part of an LDC would be unwise.[103] Although this is a private program and not a public venture, its commitment to innovative private involvement in the international debt crisis suggests that the administration would be committed to support this type of program, assuming proper implementa-

---

95. *See* Wayne, *supra* note 67.

96. *Id.*

97. *Id.*

98. *Id.* Wherever the potential for high returns exists, however, a large risk is always involved. This scenario is analogous to the way a bank's interest rate must reflect the risk involved. Therefore, one must be willing to take large risks with one's capital in order to realize the high returns from a venture such as securitization. *See id.*

99. *Id.*

100. *See supra* note 98 and accompanying text.

101. Litigation in this area often arises out of contracts to purchase or sell goods or in unstable political environments. *See, e.g.*, Alfred Dunhill of London, Inc. v. Cuba, 425 U.S. 682 (1976); Kalamazoo Spice Extraction v. Provisional Mil. Gov't., 729 F.2d 422 (6th Cir. 1984); Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398 (1964); Int'l Ass'n of Machinists v. Org. of Petroleum, 477 F. Supp. 553 (C.D. Cal. 1979); Carey v. Nat'l Oil Corp., 592 F.2d 673 (2d Cir. 1979).

102. 22 U.S.C. § 2370(e) (1988), commonly referred to as the Sabbatino Amendment because it was prompted by Banco National de Cuba v. Sabbatino, 376 U.S. 398 (1964), allows the President to suspend assistance to any country that repudiates a contract or agreement with a U.S. national. The extension of loans or other finance mechanisms could easily be molded into conformity with this statute and the result of suspended U.S. assistance to a repudiating LDC would be too devastating to be a viable option.

103. In addition to the Sabbatino Amendment, 22 U.S.C. § 2370(e) (1988), the LDCs are currently unable to be self-sufficient. They have neither the equipment nor the training, let alone the financial backing to "go it alone."

tion.[104]

In the event of troubled relations between debtor and creditor in a debt conversion, case law appears, by inference, to be in favor of the creditors.[105] Debtors will be deemed amenable to suit in the situs of the account receivable under the act of state doctrine.[106] This is contingent upon the misuse or refusal of payments of legitimate debts arising from the operation of commercial enterprises.[107] Although debt-for-equity conversions are so new as to have no case law on record to date, public policy suggests that such an expansion is reasonable and within the scope of the treaties.[108] The test for such an expansion would probably not be limited solely to commercial activity.[109] In order to circumvent the limitations of the Foreign Sovereign Immunities Act in a non-commercial setting, a direct impact on the United States would have to be shown.[110]

V. CONCLUSION

The debt crisis is far-reaching. Only through international collaboration will viable remedies to alleviate it come to fruition. The public sector must

104. For a discussion of how securitization is in accordance with the Baker plan, see *supra* note 70.

105. Alfred Dunhill of London, Inc. v. Cuba, 425 U.S. 682, 683 (1976) (holding that absent an act of state, foreign debtors must pay their creditors); *see also* Kalamazoo Spice Extraction v. Provisional Mil. Gov't., 729 F.2d 422 (6th Cir. 1984), where the court held that the act of state doctrine did not preclude a federal court from adjudicating American corporations' claims against a foreign nation based on its expropriation of the corporations' interests, in light of standards set out in a treaty between the nations.

106. Under the act of state doctrine, a domestic creditor has the privilege of being able to bring an action in a favorable forum against a debtor. The limitation on this privilege is that the transaction must be commerical in nature. For a discussion of the scope of the act of state doctrine see *Sabbatino*, 376 U.S. at 421-427.

107. *See id.* at 399; *see also Dunhill*, 425 U.S. at 687.

108. *See supra* note 106 and accompanying text.

109. The Foreign Sovereign Immunities Act, 28 U.S.C. §§ 1602-1605 (1988), promotes a restrictive theory of asserting jurisdiction over a foreign state. The commercial activity test will therefore be scrutinized on a case-by-case basis. Int'l Ass'n of Machinists v. Org. of Petroleum, 477 F. Supp. 553, 567 (C.D. Cal. 1979). The activity of private investors lending to LDCs would probably satisfy the criteria of being a commercial activity, even if the loans were made to a foreign government or instrumentality. This probability exists because a critical factor in determining whether an activity is within the commercial exception to the F.S.I.A. so as to make the foreign national amenable to suit in the United States is whether their action had a direct effect on the United States. Carey v. Nat'l Oil Corp., 592 F.2d 673, 674 (2d Cir. 1979).

110. *See* Carey v. Nat'l Oil Corp, 592 F.2d, at 675 (1979); *see also* 22 U.S.C. § 2370(e) (1988), which allows the "President [to] suspend assistance to the government of8 any country to which assistance is provided under . . . any Act when the government of such country or any government agency . . . [which has] . . . repudiated or nullified existing contracts, or agreements with any U.S. citizens or any corporation. . . ."

continue to make additional funding available to the LDCs conditioned upon productive use of such financing. Debtors must be willing to look beyond the short-term future toward longer-term goals and adopt corresponding policies. Finally, commercial institutions must make efforts to complement traditional lending practices with new financial instruments and techniques. Only in such an atmosphere of global coordination will we be able to achieve desirable long-run results without oppressive short-term conditions.

A debt-for-equity securitization process may be beneficial for several reasons. To begin with, it shows initiative on the part of the Wall Street community, a recognized financial superpower, to help alleviate international problems. The program also fits neatly into Baker's plan, and therefore will probably be supported by the creditor nations. Because the conversion will eliminate existing loans, banks will be free to complement the equitization with new, traditional loans. Furthermore, the securitization process, by its very nature, attracts investors who would otherwise not have acess to international markets. Finally, although there is no current law on the subject, similar events, which may be analogized, have been resolved in ways that suggest favorable dispositions to secure new investors in the event of litigation.

Eric J. Dale